Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In The Matter Of	)	
	)	CC Docket No. 93-251
Amendment Of Parts 32 And 64 Of The Commission's Rules To Account For Transactions Between Carriers And Their Nonregulated Affiliates	)	

REPLY COMMENTS OF THE NYNEX TELEPHONE COMPANIES

The NYNEX Telephone Companies (NYNEX)[1] submit these Reply Comments to certain parties' comments filed December 10, 1993, in the above-captioned matter.

I. INTRODUCTION

Many parties submitted comprehensive comments demonstrating that the costs of the FCC's proposals far outweigh any perceived benefits, and argued that those proposals should not be adopted.[2] NYNEX, for the reasons set forth in detail in its Comments, supports the positions advocated by these parties. It bears emphasis that only two years ago, the Commission found its then newly strengthened

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1 I.e, New England Telephone and Telegraph Company and New York Telephone Company.

2 See AllTEL, AT&T, Ameritech, Bell Atlantic, BellSouth, Cincinnati Bell, GTE, NCTA, Pacific Bell and Nevada Bell, Puerto Rico Tel. Co., SNET, Southwestern Bell, Sprint, USTA, U S WEST.

affiliate transaction and cost accounting rules to be entirely adequate and effective;[3] the Commission provides no rational basis for dramatically changing its approach here. MCI's criticism (p. ii) of the FCC's current rules repeats past MCI arguments and should summarily be rejected. Similarly, ITAA's reiteration (p. 3) of arguments favoring structural separation should be dismissed.

NTCA states (at 3, 5) that the NPRM's proposals appear to be based on the "dynamics of price caps" such that any revisions to the affiliate transaction rules should apply only to Tier 1 carriers. To the contrary, price cap regulation is a factor militating against the application of affiliate transaction rules, let alone the expansion of such rules. As the FCC has observed, "because price cap regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup misallocated nonregulated costs by raising basic service rates, thus reducing the incentive for the BOCs to shift nonregulated costs to regulated services."[4] ICA's general criticism (n. 8) of the FCC's

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3 Computer III Remand, CC Docket No. 90-623, Report and Order released December 20, 1991, 6 FCC Rcd 7571, n. 85, paras. 53-56: "the affiliate transaction rules are geared to protecting ratepayers.... Based on nearly four years experience with cost accounting safeguards, we are convinced that we will be able to continue to enforce those safeguards... and based on the record developed on remand, we conclude that our cost accounting safeguards constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy." Id. at n. 85, paras. 54, 56.

4 Computer III Remand, 6 FCC Rcd 7571, para. 55. See also id. at para. 56.

price cap regime as ineffective is incorrect and outside the scope of this matter. Overall, the LECs have strong incentives to be more efficient as they strive to cut costs in their increasingly competitive environment.

Only a handful of commentors support the FCC's proposals.[5] These parties' comments are scanty and conclusory. They do not supply concrete evidence to demonstrate that any benefits would result from the FCC's proposals that would justify the demonstrably high costs incurred as a result of their adoption. Indeed, even these parties acknowledge the burdensomeness of certain of the FCC's proposals,[6] and acknowledge that pricing decisions are driven by "competitive market" forces.[7] Further, as noted by Pacific Bell and Nevada Bell (at 6 & n. 10), by the Commission's own calculation, the requirements of the NPRM would add 320,000 hours of burden to carriers; and the NPRM is contrary to the direction of the Executive branch to reduce regulation.

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5 ICA, ITAA, MCI, PUC of Texas, Tennessee PSC. MCI's support of measures that would increase LEC costs should be placed in proper perspective given MCI's recently announced intentions to compete with those LECs in local markets. <u>See</u> The New York Times, January 5, 1994, p. D1, "MCI Plans To Enter Local Markets"; The Wall Street Journal, December 30, 1993, p. A3, "MCI Is Planning Local Networks In Major Cities."

6 ICA 5, MCI 16.

7 ICA 4.

II. THE COMMISSION'S PROPOSAL TO APPLY ASYMMETRICAL ASSET TRANSFER RULES TO SERVICES SHOULD NOT BE ADOPTED

The Commission proposes to extend its asymmetrical asset transfer rules to services.[8] That is, absent a tariff or prevailing company price, carriers must record service transactions with nonregulated affiliates at fully allocated cost or fair market value, whichever disfavors the shareholder. NYNEX has demonstrated that this proposal should be rejected.[9] Market valuation is simply inapplicable to corporate governance and ownership functions; and it would entail exceedingly high costs to perform market valuations of the wide range of interaffiliate services.[10]

The record provides additional quantitative evidence of the enormous cost burden of the FCC's proposal. For example, SNET estimates (p. 7) it would cost about $40,000 on average for each study to determine fair market value. Further, GTE indicates that the NPRM's proposal would add $11.5 million of costs to GTE; of this "GTE estimates at $3 million

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8 NPRM para. 24.

9 NYNEX 13-23.

10 Our initial Comments noted that Telesector Resources Group provides support on 500 projects to its owner, the NYNEX Telephone Companies; and NYNEX Corporation provides support on 250 functions to its affiliates, including the NYNEX Telephone Companies (NYNEX 19-20). NYNEX estimated that a fair market valuation process applied to such services would cost an average of $35,000 to $45,000 in external costs (typically, of consultants) to evaluate each individual service function. Internal costs would increase the total compliance costs significantly as would a requirement to do valuations item by item, since the number of functions described above may apply in multiple transactions that would require separate valuations under the proposal.

the annual cost of obtaining certified market valuations for services, while the annual in-house costs associated with this activity are estimated at $4 million."[11]

The parties who support the FCC's proposal fail to provide any showing of tangible public benefits that would be realized from its adoption. Yet, as MCI concedes (p. 16) the FCC's proposal would be substantially burdensome: "the resources necessary to evaluate each carrier's fair market valuation would be enormous and the Commission has indicated it might not be feasible to adopt a step-by-step approach for such valuations."[12] Similarly, ICA

> recommends adoption of a few of the less restrictive options proposed in the Notice... where such an option may be appropriate to limit the administrative burdens on the Commission staff.... The Commission should consider allowing carriers to use somewhat more "streamlined" approaches to costing affiliate transactions, than the detailed item-by-item approaches discussed in the Notice.[13]

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11 GTE 2, 16. To similar effect, see AT&T; Ameritech 12-19 (burden of calculating fair market value for each of two hundred service transactions; competitive bidding process would not be appropriate for many service transactions of a sensitive and proprietary nature); BellSouth 10-12 (Theodore Barry & Associates reviewed BellSouth's affiliate transactions and concluded that, although determination of fair market value of assets follows generally accepted methodologies, applying a fair market value test to "knowledge-based services" is less feasible and risks inconsistency); Southwestern Bell 23-25 (fair market valuation requirements would create additional annual costs of $5.9 million); USTA 10 ("it would cost an average of $40,000 to obtain an estimated fair market value for a particular affiliate transaction. This would translate to a cost for Tier 1 carriers of approximately $91 million.")

12 MCI goes on to recommend a streamlined approach whereby the FCC would examine service transactions of particularly significant valuation or magnitude (MCI 16-17).

13 ICA 5, 11.

III. THE CURRENT RULES ARE SUPERIOR TO THE COMMISSION'S BRIGHT LINE TEST

Proposing to "curtail sharply" its reliance on prevailing company prices, the Commission recommends a "bright line" test requiring that 75% of an affiliate's output be sold to nonaffiliates to establish eligibility for use of prevailing company prices in recording affiliate transactions.[14] NYNEX demonstrated that (pp. 24-26) the FCC's current rule is logical, protects ratepayers and need not be changed; the 75% benchmark is too high and not consistent with the economic theory underlying the current rule.

The record provides substantial support for NYNEX's position. For example, Southwestern Bell has demonstrated the mistaken and unsupported nature of the NPRM's assumption that interaffiliate services entail less marketing efforts: "The NPRM's assumption is flawed because of the fact that the affiliates always have at least three options in the acquisition of resources: 1) buy the service from an affiliate, 2) buy the service from a nonaffiliate, or 3) provide the service internally."[15] The NPRM's attempt to draw distinctions between affiliates which "have a primary purpose to serve the carrier" and those which do not is unnecessary and irrelevant to the real issue of whether a prevailing price has been established through arm's length

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14 NPRM paras. 15, 19, 21-22.

15 Southwestern Bell 10.

market transactions with nonaffiliates.[16] Accordingly, the relationship between affiliates is simply not probative of prevailing company price.

MCI states that nonregulated affiliates having a primary purpose to serve the carrier and other affiliates, may not appropriately use prevailing company price because the relationship between LECs and the nonregulated affiliates does not represent arm's length transactions.[17] MCI confuses the prevailing company price -- which is the price of a transaction between a carrier's nonregulated affiliate and an unaffiliated party, certainly an arm's length transaction -- with the nature of a transaction between the LECs and their nonregulated affiliates. The fact that the transaction between the LECs and their nonregulated affiliates may not be at arm's length is addressed through the application of an arm's length transaction price, i.e., the prevailing company price which is the result of arm's length transactions with third parties.

MCI also asserts that the proposed 75% criterion should be applied on an individual product or product line basis.[18] MCI contends that a total company or line of

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16 Southwestern Bell 10-12. See also AT&T, Ameritech, BellSouth, Cincinnati Bell, GTE, SNET, Southwestern Bell, Sprint, USTA.

17 MCI 4.

18 MCI's comments reflect its misunderstanding on the subject. Its statement on p. 4 that "carriers... can simply increase their overall profits by collecting their authorized rate of return on expenses..." is simply incorrect because authorized rate of return is applied to the rate base, not to expenses.

business basis "would result in product and service mixes where the pricing of any individual service could have no relation to the pricing of the other, effectively rendering completely meaningless the 75% test.[19] Again, the 75% test itself is meaningless; and therefore NYNEX has proposed that the flexibility incorporated in the existing rules should be maintained. It should be noted, however, that MCI confuses the meaningless 75% test with the individual price. It is true that the total company approach would result in a different product and service mix. However, the prevailing company price, based on arm's length transactions with unaffiliated parties, is on an individual product or service basis and would not result in commingling.

IV. A RATE OF RETURN OF 11.25% ON INVESTMENT WOULD BE APPROPRIATE WITH RESPECT TO AFFILIATE TRANSACTIONS

The FCC proposes to require use of 11.25%, the currently prescribed interstate rate of return, as the return on investment component of fully allocated costs recorded for affiliate transactions; and the FCC invites comments on other options.[20] NYNEX's initial Comments (at 33-34) supported the use of 11.25%, as well as the option of using a different rate of return so that a carrier could meet its obligations to both federal and state regulators and reduce its record-keeping burden. The record significantly supports our position.[21]

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19 MCI 13.

20 NPRM paras. 66-71.

21 _See_ Ameritech 23-24, Pacific Bell and Nevada Bell 22-29, Sprint, USTA, U S WEST 30.

MCI proposes that the lowest part of any FCC-authorized range for rate of return be used for affiliate transactions.[22] MCI's reason for using the low end of the range is merely its opinion that the 11.25% authorized rate of return is too high.[23] That subject is outside the scope of this docket, however. The issue before the Commission is the proper rate of return to be used for affiliate transaction purposes, given the rate of return authorized in the particular regulatory environment.[24]

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22 MCI 9.

23 MCI 11.

24 MCI also argues that nonregulated affiliates do not have similar capital requirements as LECs with regard to infrastructure investment, and therefore that the unnecessary component should be eliminated from those affiliates' authorized return (MCI 11). MCI's argument is not persuasive. MCI seems to presume, but without any supporting evidence, that nonregulated affiliates do not support the communications infrastructure; and MCI only addresses one of many factors that may affect capital requirements. In any case, the determination of cost of capital and rate of return for particular nonregulated affiliates or lines of business would be extremely complicated and is certainly beyond the scope of this matter.

V. CONCLUSION

The Commission should decline to adopt additional, costly and burdensome affiliate transaction rules that would disserve the public interest.

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and
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Dated: January 10, 1994

CERTIFICATE OF SERVICE

I, Susan Markis, hereby certify that on January 10, 1994, a copy of the foregoing REPLY COMMENTS in CC Docket No. 93-251 was served on each of the parties listed on the attached Service List by first class U.S. mail, postage prepaid.

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